RBC2 HOLISTIC AND LEGAL REVIEW

PART 3: ANALYSIS OF THE LAW BEHIND THE NCUA RULE

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LEGAL DISCLAIMER

PART 3: ANALYSIS OF THE LAW BEHIND THE NCUA RISK BASED CAPITAL RULE

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For over a year, the NCUA has focused on implementing a Risk Based Capital Rule ("RBC") and a two-tiered[1] risk based net worth (RBNW) system. Despite soliciting the services of an international law firm and the NCUA's insistence, the legal authority for the NCUA to implement this two-tiered Rule is murky at best. In fact, not only did NCUA Board Member the Honorable J. Mark McWatters ("McWatters") state clearly in his dissent his belief that the NCUA has exceeded its powers, there are many qualifiers and concerns raised by the NCUA's own opinion on the matter.

Credit unions opposed to the rule should investigate the costs of bringing a legal challenge to the RBC Rule. Of course, legal challenges to a federal agency's authority are difficult and expensive undertakings. Credit unions should continue to push back on all aspects of the Rule and not rely on a court to swoop in and render the whole controversy moot. In particular, credit unions should continue to push the NCUA to drop the idea of granting the RBNW formulas the authority of law. **At stake is the NCUA's ability to increase the number of credit unions placed under Prompt Corrective Action ("PCA")**[2].

The NCUA and the credit union industry would be served better if the formulas and risk weights within RBC were not given the force of law, but rather were used as guidelines. As guidelines, the NCUA would have greater flexibility to take in consideration the field of membership of the credit union and its charter, and would help identify areas of potential risk without forcing a credit union to institute changes both potentially drastic and unwarranted in the institution's balance sheet.

Question of RBC Legality

The NCUA first promulgated the RBC Rule in 2014, which contained a comment period. Based on commentary from the industry, the NCUA released a new RBC Rule with substantive changes in 2015 ("RBC2"). A rebuke brought up by the 2014 commentators - that clearly stung the NCUA - was the argument the NCUA lacks legal authority to issue a two-tiered RBNW system. According to the NCUA, concerns over the legality of the rule caused the agency to solicit the opinion of eleven different law firms. Furthermore, the NCUA paid $150,000 to the international law firm Paul Hastings, LLP ("Paul Hastings") to render an opinion on RBC's legitimacy. In a December 30, 2014 legal memorandum Paul Hastings stated that "a court … could conclude" the NCUA has the statutory authority. The "could" language was seized by McWatters as providing "little comfort" to the NCUA. McWatters went further, and in an unusual move provided grounds for challenging the Rule in federal court. McWatters dissent, coupled with the qualifications in the Paul Hastings memorandum, demonstrates that the legal grounds cited by the NCUA are not especially strong.

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[1] Meaning one tier for "well capitalized" credit unions, and another for "adequately capitalized" credit unions. The key is that a credit union would need to meet *both* the current definition of having a net worth ratio of 6% to be adequately capitalized or 7% for well capitalized, *and* whatever RBNW criteria set forth in the RBC Rule.

[2] The NCUA has very broad power to take serious action against credit unions who fall into PCA. For example, an Adequately Capitalized credit union that misses its Net Worth quarterly target by even a single dollar could be categorized as Undercapitalized, granting the NCUA the power to dismiss directors and officers and restrict lines of business to members.

Moreover, directors and officers may face litigation from the NCUA. If a credit union fails, the NCUA may initiate a legal case against a credit union's directors and officers to cover losses not covered by the Fund. More information on the negative effects of RBC and PCA can be found here.

A Brief Primer on the Administrative Law Issues Surrounding RBC

As an independent federal agency, the NCUA must rely on Congress to grant it authority to enforce legislation. This law is called administrative law, because agencies such as the NCUA are administrating the law of Congress. A federal agency has broad power to interpret and create Rules based on Congressional statutes, but is constrained by both the language of the statute and the intent of Congress. Courts have the power to invalidate an agency's rules if there is a showing that the agency exceeded its authority or passed a Rule that is contrary to Congress.

The primary administrative law that will likely determine whether the two-tiered RBC2 system is invalid exercise of the NCUA's powers is the Federal Credit Union Act, as amended by the Credit Union Membership Access Act, and the Supreme Court case of *Chevron*.

Statutory Background

In 1998, Congress passed the Credit Union Membership Access Act (CUMAA). CUMAA added section 216 to the Federal Credit Union Act (FCUA) stating, in part:

(d) Risk-based net worth requirement for complex credit unions.—

(1) **In general.—**The regulations required under subsection (b)(1) of this section shall include a risk-based net worth requirement for insured credit unions that are complex, as defined by the Board based on the portfolios of assets and liabilities of credit unions.

(2) **Standard.—**The Board shall design the risk based net worth requirement to take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection.

The NCUA's legal opinion published on pages 7-16 of the RBC2 Rule contains the agency's justification to create the new RBNW Rule.

Chevron

The Paul Hastings firm in its memorandum bases much of its argument in favor of the NCUA on *Chevron v. v. Natural Resources Defense Council, Inc.* (*Chevron*), decided in 1984.

Chevron is one of the most cited cases regarding the rulemaking power of federal administrative agencies. The Supreme Court said that if an administrative agency creates a rule, the agency is granted "deference" to do so, so long as (1) the underlying statute is *ambiguous or silent* on the matter presented, and the (2) agency's interpretation of the statute is *permissible.*[3]

As a mathematical formula, it might look like this:

If Congress says agency needs to accomplish X, agency can do so by creating rule Y, *unless*:

Congress said to accomplish X, the agency *must* do Z; or

Congress said agency *may not* do Y; or

The agency's interpretation of X is "arbitrary and capricious"[4]; or

The agency's interpretation is *impermissible* based on X.

The *Chevron* tests are fairly limited challenges to a federal agency's authority. However, as McWatters mentioned in his dissent, these challenges may be enough to stop the NCUA from implementing the RBNW Rule.

The NCUA won a challenge against the American Bankers Association in 2001 that was partially based on the *Chevron* doctrine. Of course, that case is materially different than a potential case challenging the RBC.

[3] Per the *Chevron* opinion:

> *First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.*
>
> *[Second,] if the statute is silent or ambiguous with respect to the specific issue, the question for the court to decide is whether the agency's answer is based on a permissible construction of the statute.*

Challenge to the NCUA: Complex Definition

The FCUA limits the imposition of RBNW requirement to "complex" credit unions. The NCUA modified RBC2 to define complex credit unions as having total assets over $100,000 (up from $50,000 from the first draft of RBC). The NCUA agrees that credit unions that are not complex cannot required to meet RBNW standards. The NCUA is using this $100,000 asset threshold as a "proxy" for the assets and liability language within the FCUA itself.

While neither McWatters, nor the NCUA in its legal opinion or in the Paul Hastings memorandum makes mention of this fact, there is a potential challenge in the way the NCUA is defining complex. Per the legislative history of CUMAA:

> New section 216(d) requires the NCUA, by regulation, to prescribe a risk-based net worth requirement for federally insured credit unions that are complex, as defined by the NCUA. For purposes of section 216(d), "complex" refers to credit unions' portfolios of assets *and liabilities*; it does not involve credit unions' field of membership. [*emphasis added*]

Based on the legislative history and plain language of the statute, this use of a "proxy" may not be valid.

Congress intended for the NCUA to develop rules around credit union complexity that would take into account the diverse nature of credit union balance sheets. An arbitrary asset cut-off point is contrary to the mission Congress provided to the NCUA, which is to take in account the special nature of credit unions and consider the balance sheet in total, without special reference to the field of membership.

Challenge to the NCUA: Has Congress Spoken?

This question is fundamental to whether a legal challenge against RBC2 would succeed. At issue is this language in 216(d):

> [The NCUA Board] shall design the risk based net worth requirement to take account of any material risks against which the net worth ratio *required for an insured credit union to be adequately capitalized* may not provide adequate protection. [*emphasis added*]

Does the inclusion of the language "to be adequately capitalized" restrict the NCUA from *only* creating an RBNW for adequately capitalized credit unions, or does it allow the NCUA to create two tiers, one for adequately capitalized and one for well capitalized?

The NCUA believes the latter, and the justification rests on four arguments, per Paul Hastings:

1. The *plain language* of Section 216(d)(2) does not expressly restrict the NCUA from imposing a higher RBNW requirement for "well capitalized" versus "adequately capitalized" credit unions for the supervisory purpose of building in additional risk management controls before a credit union becomes undercapitalized.

[4] "Arbitrary and capricious" is a legal term of art meaning the agency abused its discretion or took action without observing a procedure or procedures required by law. This is a very easy bar for a government agency to overcome, although overturning an agency's rule has happened before under this doctrine. A state law example is when a judge struck down New York City's ban on sugary drinks in 2013, and was upheld on appeal in 2014.

2. The use of the word "requirement" in *singular form* does not preclude the NCUA from creating two-tiered requirements.

3. Congress, by making the "undercapitalized" category *an "or" test* (a complex credit union is undercapitalized if it falls below 6% net worth ratio *or* fails the applicable RBNW test), allows the NCUA to set forth a separate RBNW requirement for well-capitalized, adequately capitalized, and undercapitalized.

4. Section 216 mandates that the NCUA create a *"comparable"* PCA system for banks.

Discussion of the weaknesses of these arguments is below. Note that the NCUA would not need to prevail on *all* of these arguments; in fact, the NCUA might need just one (or another argument not made here) in order to convince a court that it has the authority necessary to issue the Rule.

Plain Language of 216

As mentioned by McWatters, when Congress placed the "adequately capitalized" language in Section 216(d)(2), Congress was making a clear statement that it expected to use RBNW to *only* prevent adequately capitalized credit unions from falling into the undercapitalized category. The reference to well capitalized credit unions meeting the RBNW test did *not* mean a separate test for each category.

The inherent weakness of the NCUA's argument is illustrated by this quote from Paul Hastings:

> Thus, a reasonable interpretation of Section 216(d)(2) is that the NCUA is being asked to identify material risks that could cause a credit union to become undercapitalized, and to design a RBNW requirement that protects against those material risks. Such a requirement *could reasonably impose different degrees of protection* for "well capitalized" and "adequately capitalized" credit unions so that well capitalized credit unions are further insulated, and appropriately, more protected than adequately capitalized credit unions against the material risks that could cause *each of such credit unions* to become undercapitalized. [*emphasis added*]

That's an interpretation that goes beyond the plain language of the statute. The NCUA has to reach for this argument by interpreting that it can "reasonably impose" additional insulation. This interpretation is not supported by the plain language of the text itself.

The NCUA has to reach by arguing that the agency meets the regulation by creating a separate "well capitalized" tier, when the plain language of Section 216 refers *only* to "adequately capitalized credit unions." The NCUA's support is that the agency "could reasonably impose different degrees of protection" when the statute itself says no such thing.

Damning to this NCUA's argument is that when the agency attempted to modify 216(d) in 2007, the NCUA *agreed* with argument that the statute *precluded* the reading the NCUA is looking to impose:

> The statute (§1790d(d)(2)) requires NCUA to "design the risk-based net worth requirement to take account of any material risk against which the net worth ratio required for an insured credit union to be adequately capitalized may not provide adequate protection." *In relation to the risk-based net worth requirement, the statute precludes a distinction between Well Capitalized and*

> *Adequately Capitalized*, and a credit union failing the risk-based net worth requirement is classified no lower than Undercapitalized. [*emphasis added*]

It should be noted that Congress did not see fit to amend the statute in 2007, or since.

As pointed out in the Hon. J. Mark McWatters' dissent, the NCUA has pivoted away from its own long-standing interpretation of Section 216(d) of the Federal Credit Union Act. In 2007, the NCUA asked Congress to amend the regulation because the NCUA said they needed the authority to create a two-tiered Risk Based Capital test. Now, the NCUA says it has all the authority it needs, despite the fact Congress made no changes to the statute.

"Requirement" is Singular

The Paul Hastings memorandum argues that the fact Congress mentioned a RBNW "requirement" in singular form is not dispositive, in part because:

> Had Congress intended for only one RBNW requirement to apply in all cases for all complex credit unions in different capital categories, rather than referring to "any applicable" requirement in Section 216(c), Congress could have specifically indicated its intent for "the" or "the same" rather than "any applicable" risk-based net worth requirement for both the adequately capitalized and well capitalized categories. Accordingly, as written, Section 216(d) does not clearly and unambiguously prohibit the NCUA from establishing a two-tier rather than single-tier RBNW requirement.

However, the legislative history of the regulation challenges this interpretation by referring to "the" risk based capital requirement:

> Other provisions of section 301 are intended to encourage the NCUA, in designing *the risk-based capital requirement*, to seek and receive broad input--to help assure that *the requirement* is workable, fair, and effective … Although section 301 does not set a deadline for publishing in the Federal Register proposed regulations implementing *the risk-based net worth requirement*, it nonetheless contemplates that the Board would publish such regulations for public comment, as required by the Administrative Procedure Act. 5 U.S.C. Sec. 552(a). [*emphasis added*]

The Paul Hastings memo partially uses the support of the 2007 NCUA PCA proposal:

> We also note that even when the NCUA sought congressional authority in April 2007 to change the statutory language in the FCUA to expressly mandate the NCUA to implement a two-tiered RBNW requirement, the NCUA did not seek to change the word "requirement" to "requirements."

This argument is in fact true; but if the 2007 NCUA memo is legally accurate shouldn't the conclusion that the NCUA is precluded from making a two-tier RBNW also prevail?

The NCUA is prepared to argue that the fact that the use of the singular "requirement" in Section 216 does not clearly and ambiguously prohibit the NCUA from establishing the two-tiered RBNW requirement. However, the legislative history of the regulation *does* refer to the "requirement" in singular. This also agrees with the Hon. J. Mark Watters' mention in his dissent that members of Congress who actually presided over this regulation did not intended for the NCUA to create two-tiers of capital requirements.

"Or" Test for Undercapitalized Credit Unions

The NCUA argues that the test for what is an undercapitalized credit union grants the NCUA flexibility in creating multiple tiers of capital requirements. The Paul Hastings memo itself discusses the weakness of this approach:

> Unlike the definitions of "well capitalized" and "adequately capitalized" set forth in Section 216(c)(1)(A) and (B), respectively, which require a credit union to meet both a net worth ratio requirement *and* a RBNW requirement, the definition for the "undercapitalized" PCA category imposes a disjunctive test - i.e., a credit union is deemed to be "undercapitalized" if "(i) it has a net worth ratio of less than 6 percent; *or* (ii) it fails to meet any applicable risk-based net worth requirement under subsection (d)."
>
> Some may interpret this distinction as supporting the view that Congress intended for NCUA to establish only a single RBNW requirement that is the "applicable" requirement for all complex credit unions, including for purposes of determining whether a credit union is undercapitalized. [*emphasis in original*]

As with Section 216(d), to reach the NCUA's view the words of the statute need to be stretched. Simply by reading the text the plain meaning of the words indicate an intent by Congress to create a single tier RBNW requirement.

When Congress created the RBNW test, its plain meaning is that there is a single RBNW requirement that is the applicable one for all complex credit unions. This singular requirement forms the basis as to whether or not a credit union can be classified as undercapitalized.

Comparable to the Federal Deposit Insurance Act

The Paul Hastings memo also relies on the legislative history of CUMAA, which requires an RBNW to have "equivalence in rigor" to the test for banks. The memo goes on to suggest the two-tiered system meets this "rigor" test comparable to the FDIC:

> With respect to the particular vulnerabilities of credit unions relative to capital, imposing a two-tiered RBNW system appears to be the type of equivalence in rigor required to address the "lessons learned" by the NCUA in dealing with "several hundred millions of dollars in losses ... of [failed] credit unions holding inadequate levels of capital relative to [their] levels of [portfolio] risk" that previously ignored warnings from NCUA officials "to hold higher levels of capital to offset the risks in their portfolios." 79 Fed. Reg. 11186.

However, this Federal Register as cited by Paul Hastings is many years after CUMAA was passed.

As mentioned by the Hon J. Mark McWatters, the NCUA cannot just "piggyback" on to the FDIC unless they have the authority from Congress to do so. The plain language of the statute contradicts the NCUA's interpretation. After all, if the NCUA was to be given the same PCA authority as the FDIC, Congress could have done exactly that. The clear intent of Congress was to create a separate system for credit unions, and the NCUA must operate within those confines.

Challenge to the NCUA: Is RBC a Permissible Construction of the Statute?

If a court determines that Congress has not spoken or is ambiguous, the next question is whether the rule is a permissible construction of the statute. This *Chevron* question will grant considerable deference to the NCUA. However, the NCUA's prior acts and interpretation leave it vulnerable to a legal challenge.

Arbitrary and Capricious

The biggest hurdle the NCUA has is that its prior acts and interpretations are at odds with the new RBC2 Rule. As mentioned by Paul Hastings:

> In regard to whether the NCUA's interpretation may withstand *Chevron* scrutiny and, in particular, whether the interpretation is arbitrary and capricious, the NCUA could encounter challenges with respect to its prior interpretation and actions in implementing Section 216. For example, the NCUA's prior regulations implemented the RBNW requirement in Section 216(d) by establishing a system with a single tier structure, or alternatively, as a system that imposes multiple RBNW requirements where each complex credit union is subject to its own unique RBNW requirement. *See* 12 C.F.R. Part 702. The NCUA has held this position in the agency's regulations since 2000. *See* 65 Fed. Reg. 44950 (July 20, 2000). In its original proposed rule in 2000, the NCUA stated the "NCUA Board has determined that a 6 percent net worth ratio is sufficient to protect against an average level of risk, but that a measure of additional net worth is needed to compensate for risks which are above average. For this reason, the final rule limits the scope of its RBNW requirement to credit unions that have an above average level of risk exposure." *Id.* at 44955. Additionally, the U.S. Treasury Department assessed the NCUA's implementation of Section 216 in 2001 and found that "[i]n general, the NCUA implemented the RBNW requirements as Congress intended." *See* Treasury Report Required Under Sections 401 and 403 of the CUMAA, *Comparing Credit Unions With Other Depository Institutions,* p. 14 (Jan. 2001). Thus, the NCUA's current two-tier interpretation in the Proposed Rule, viewed in light of its prior interpretation and implementation of a single-tier RBNW requirement, could be viewed as an arbitrary change in position and, as such, may be susceptible to challenge under *Chevron's* arbitrary and capricious standard.

The NCUA was advised by Paul Hastings to bolster its arguments by adequately explaining the reasons for a reversal of policy, in particular market conditions that would justify a two-tiered standard. While not dispositive, courts can credit prior agency statements of position. This argument against the rule has strength when added to the fact, as mentioned earlier, that the agency applied in 2007 for Congress to amend the statute to grant the these very same powers, and Congress did not

do so. Courts have held that even if statutory language is ambiguous the agency's interpretation does not require automatic deference.

The NCUA has held the position since the year 2000 that the agency lacks the authority to implement a two-tiered RBNW requirement. The NCUA took the single tier RBNW requirement to the Treasury Department, which signed off on the NCUA's implementation. Further the NCUA attempted to amend the regulation in 2007 to expressly allow for a two-tiered RBNW requirement, and Congress did not do so.

Conclusion

Credit unions should consider a legal challenge to RBC2 if it is implemented by the NCUA. Not only does the NCUA's own legal documents illustrate some of the weakness in its interpretation, a Board Member has provided a roadmap of attacking the legality of the NCUA's position. In addition, other credit union advocates may also look into the legal reasoning used by the NCUA and find it wanting.

The NCUA should reconsider implementing a two-tiered RBNW that is at odds with the agency's past interpretation of its powers, and which conflicts with the plain language and intent of Congress. Not only has an NCUA Board Member strongly dissented from the NCUA's proposed Rule, but the legal foundation the NCUA is relying upon is weak. Much of the weaknesses in the NCUA's arguments can be found directly in the memo prepared by the Paul Hastings, LLP, law firm.

The NCUA is straining hard to justify its legal interpretation of a Rule that has significant practical problems. The $100,000 asset size cut off is arbitrary. The risk weighting is arbitrary. Adherence to this Rule could cause credit unions to build up concentrations in assets that turn out to be risky. Why doesn't the NCUA allow for a Rule that allows for supplemental capital, which would likely be far greater benefit to the industry and greatly reduce the risk to the Share Insurance Fund?

Finally, why should the industry accept RBC when it suffers from these problems and may very well be an overextension of the NCUA's authority in any event?

The industry should be prepared to challenge the other aspects of the Rule as well, as legal challenges are certainly not guaranteed and American jurisprudence generally favors the rulemaking authority of government agencies. Having said that, the credit union industry has little to lose from such a challenge. Courts will find the Rule to be valid or not; if valid the credit unions will be operating under it anyway. Success, and the NCUA may retreat from some of the more onerous positions it holds with respect to credit union safety and soundness.